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Investment Outlook

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Big Headlines, Little Action Coming From Washington

In case you missed it, here's a quick recap of the summer. In June Fed Chairman Bernanke stated the obvious: Sometime in the future Quantitative Easing would end. Later, chemical weapons were unleashed in Syria and, as a result, geopolitical tensions spiked. Then, speculation over who would succeed Ben Bernanke reached a fever pitch. And what eventually transpired? Nothing. The same old same old: Lots of talk and no action coming from our nation's capitol. Investors liked it. While this news dominated the airwaves, the markets remained on track with nary a correction. Now, our political leaders have returned to their desks and are ready to ramp up the rhetoric as they wade back into the ideological battlefield that Washington has become. The next Crisis du Jour is the continuing resolution to fund the government and later, a vote to raise the debt ceiling. Today we awoke to a shutdown of the government and a mini-rally in stocks. The media's loving it because it sells advertising but this time a few weeks of all talk and no action could bring about the stock market correction that some investors have been expecting for months.

Lots of News But Little Action

Here's a quick summary of what happened this past summer and how the markets reacted:

The Fed – In May we were introduced to a new term, Tapering. It's defined as the scaled reduction in purchases by the Fed of US debt obligations. This could otherwise be referred to as the "beginning of the end of Quantitative Easing" or the more popular "Removing the Punchbowl". Whatever term is used, the markets didn't like it. Stocks and interest rate sensitive investments took a dive in May and June when the Fed stated what should have been obvious to all: extraordinary measures used to stimulate the economy will be curtailed as the economy strengthens and returns to a level of sustainable organic growth. *This is akin to putting your umbrella away when it stops raining.* However, credit-addicted investors viewed it as a reason to sell securities and rethink real estate purchases. When the dust settled, the S & P 500 had retraced less than 5% before resuming its uptrend to make new record highs.

The decision in September not to Taper was one that many experts didn't see coming. The Fed had formally stated that any decision to reduce QE would be dependent on data showing Unemployment at 6.5% and inflation at 2%. With those numbers at 7.3% and 0.1% respectively, the Fed's decision not to taper was a no-brainer. However, the media and 60% of economists polled were on the wrong side of that bet. As we await the next Fed statement on October 29, the buzz that Ben will taper inexplicably persists. Yes it could happen, but it's unlikely given the potential economic fallout from the shutdown. **We look for tapering to begin sometime next year IF Washington can break out of its gridlock and the Fed's stated milestones are reached.** We're focused on the inflation number as being critical and believe we could see the unemployment benchmark revised or abandoned altogether. If inflation hits 2%, we see Tapering starting soon after that.

Syria – Chemical weapons were deployed in Syria. The US cried foul and announced it would punish those responsible with an "incredibly small attack". The Rest of the World said "why bother" and followed Russia's diplomatic lead, using sanctions instead of missiles to "punish" the Assad regime. The markets flagged briefly, again less than 5%, until the administration's rhetorical retreat hit the front pages. Then it was back to business as usual and another advance for the stock market.

The New Fed Chairman – Remember Larry Summers? Plenty of folks in Washington did and wrote letters to their president. Actually, it was those in Congress that wrote the letters, promising to withhold votes for ratification of Summers as the new Fed chairman. It was a rare display of bi-partisanship that speaks volumes about the memory of Summers as one of the chief architects of the 2008 financial crisis. There was also mention of comments by him that were interpreted by the media to disparage the math skills of women. True or not, the White House was going to have a battle on its hands in Congress to go along with its mishandling of the Syria situation. Mercifully for the president, Larry removed his name from consideration and investors enjoyed the "Summers" rally that took stocks and bonds to another record high.

Each of these headline-grabbing events were portrayed as market-busters by the visual media but turned out to be mere blips on the radar rather than buying opportunities as stocks continued to track higher. In our view, none of these events threatened the long-term trajectory of the global economy and that's what investors should be on the lookout for. Once again, we caution investors that commercial TV outlets are entertaining first and informative last when it comes to the markets. The next "hot" trade and multiple yelling-heads on the screen sell advertising rather than convey thoughtful, reasoned analysis. The Financial Times, The Economist, Barron's and the Wall Street Journal are among many great sources of financial information and analysis for investors. Websites like MorningStar and Zacks are worthy online sources. Any website that sells an extreme view of the world along with a product should be avoided. **If you're a trader, by all means get your ideas from CNBC and Bloomberg. If you're an investor, change the channel.**

"Ramping Up The Rhetoric"

That's what happens when Congress and the Administration return to Washington following their summer hiatus. The next awe-inspiring crisis to be endured is the battle over the Affordable Care Act ("ACA") and its ramifications on Congress approving a Continuing Resolution to fund the government. After that, we will have a vote to increase the debt ceiling later this month. Today, the government ceased operations for the 17^{th} time since 1977. Critical areas such as Military, Public Safety, and Social Security remain unaffected. Those employees in non-critical areas will be furloughed. This shutdown is likely to be brief and could be viewed as a "Mini-Sequester" so to speak. Anything longer than a week could modestly impact the US economy beyond the short-term. The bigger issue will come to a head in the middle of October. **Failure to raise the debt ceiling would be a first time for the US to renege on paying its bills and could have serious ramifications for the global economy. We don't see that happening.**

The networks are giving voice to those in Congress and the White House who play the blame game and warn of "financial disaster" if things don't go their way. We're not watching or listening. We're investing in the "thinkable" scenario of compromise and resolution rather than the unthinkable where Congress and the administration quit talking altogether and let this badly written piece of theater play itself out to a conclusion that derails the recovery. We're betting there will be no financial disaster. There's too much blame to be shared and political capital to be squandered in advance of next year's mid-term elections. Those in Washington are foolish but not bent on committing career suicide.

However long the shutdown persists, one thing appears sure. It's likely to dampen consumers' enthusiasm for spending and act as a drag on the recovery. If that proves to be the case, look for the Fed to defer Tapering into next year. *That's why we view any meaningful pullback in the stock market as an opportunity to put cash to work.* We're not there yet with the S & P 500 hovering only 2% below its all-time high of September 18^{th}. If the shutdown extends beyond next week and translates into a fight over the debt ceiling, we'd look for a correction (>10% retracement from the most recent high). That would mark a significant buying opportunity for investors.

Following resolution of the debt ceiling, we see the market tracking higher into next year. Why? Europe continues to recover slowly and, as Asia's biggest customer, that growth translates to better days for the Emerging Markets as well as the US. With the new Fed chair manning the last line of defense for this recovery, we expect monetary stimulus to continue until Washington gets its act together and that could be for some time. That's a potent combination for the global economy and equities and news that's overshadowed by what's happening during the Silly Season in Washington.